[COMMITTEE PRINT]

PROPOSED INCOME TAX TREATY BETWEEN THE UNITED STATES AND THE UNITED KINGDOM

PREPARED FOR THE USE OF THE

COMMITTEE ON FOREIGN RELATIONS

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This pamphlet describes the proposed income tax treaty between the United States and the United Kingdom of Great Britain and Northern Ireland. This pamphlet covers the treaty as assigned by both governments on December 31, 1975, and as amended by a subsequent Exchange of Notes and two Protocols. The proposed treaty, as amended, has been submitted to the Senate for advice and consent to its ratification. The proposed treaty, as amended by the Exchange of Notes and the first Protocol, has been approved by the United Kingdom House of Commons.

The proposed treaty is to replace the existing tax treaty between the United States and the United Kingdom signed on April 16, 1945, and subsequently amended. The proposed treaty is intended to modernize the relationship between the two countries with respect to income taxes and to take into account the changes in their income tax systems.

The proposed treaty is substantially similar to other recent United States income tax treaties, and to the model tax treaty of the Organization for Economic Cooperation and Development (OECD). There are, however, several provisions in the proposed treaty with the United Kingdom which require special comment.

1. The proposed treaty contains a new provision (*Article 9(4). Associated enterprises*) not found in other United States tax treaties or in the OECD model tax treaty, which places limitations on the combined reporting method used by several States of the United States to determine the taxable income which corporations derive from sources within the State. Under this apportionment method, there is taken into account on a consolidated basis the operations of all related corporations (both domestic and foreign). The proposed treaty provides generally that in determining the tax liability of a British corporation doing business within a State, or of any subsidiary (U.S. or foreign) doing business within a State which is controlled by a British corporation, the State may not use the combined reporting method to take into account the operations of any related foreign enterprise which is not doing business within the State. This treaty provision would have a significant impact on those States where combined reporting on a unitary basis is frequently required. It represents the first attempt to bind State and local by a substantive provision of a treaty (other than nondiscrimination).

2. The proposed treaty contains a new and complex set of provisions (*Article 10 and 23*) with respect to the taxation of dividends which are designed to accommodate the problems which are presented by the interaction of the U.S. system of corporate taxation and the new hybrid system adopted by the United Kingdom in 1973 which in part integrates corporate and shareholder taxation. Under the new

British system, a tax is imposed upon U.K. corporations with respect to dividend payments (the Advance Corporation Tax, or ACT) and it is refunded to U.K. shareholders. No refunds are paid to nonresident aliens, however, in the absence of an income tax treaty.

Under the proposed treaty, the U.K. is to provide full refunds of the ACT to U.S. portfolio investors (individuals and corporations owning less than a 10 percent stock interest) in British corporations, but the ACT refunds and dividend payments are to be subject to a 15 percent withholding tax. In the case of U.S. direct corporate investors (corporations owning at least 10 percent of the U.K. corporation's stock), the proposed treaty provides for a refund of one-half of the ACT, but also for a 5 percent withholding tax on the dividend and the refund.

The proposed treaty also provides for rules for the treatment of the ACT for U.S. foreign tax credit purposes and provides for the allowance of an indirect foreign tax credit for ACT which is not refunded.

The United States agrees to reduce its withholding tax to 15 percent on dividends to United Kingdom portfolio investors and to 5 percent on dividends to United Kingdom direct investors.

3. The proposed treaty provides (*Article 23*) that the U.K. Petroleum Revenue Tax (the PRT) is to be treated as a creditable income tax for U.S. foreign tax credit purposes. The PRT is imposed at a 45 percent rate on assessable profits from oil and gas extraction activities in the United Kingdom (including the North Sea) on a field-by-field, basis. It is in addition to, and separate from, the regular U.K. corporate tax and a separate royalty. There is some question whether, in the absence of this provision, the PRT would be treated as a creditable tax under the criteria used by the Internal Revenue Service.

4. The proposed treaty contains a separate set of rules, not contained in the existing treaty, which govern the taxation of income earned by public entertainers and athletes. (*Article 17*) These rules provide that public entertainers and athletes who are resident of either the U.S. or the U.K. and whose gross receipts from performing in the other country exceed $15,000 for the year may be taxed by the country where the services are performed on that income. These rules insure that highly paid entertainers and athletes will be taxable in the country where they perform regardless of the length of their stay in that country.

5. The proposed treaty provides that income derived by a U.S. enterprise from the operation in international traffic of ships or aircraft is exempt from British tax and that such income derived by a British enterprise is exempt from U.S. tax.

In addition, the exemptions also apply to shipping and air transport profits derived by U.S. and British enterprises from the participation in a pool, joint business, or international operating agency even where the other participants are not U.S. or British enterprises. These exemptions are broader than the exemption customarily provided in U.S. tax treaties (including the existing U.S.–U.K. tax treaty) under which shipping and air transport income of a resident of one country is exempt by the other only if the ships and aircraft are registered in the first country.

6. The treaty also clarifies the manner in which the United Kingdom may tax the United States source income of United States citizens residing in the United Kingdom and United Kingdom branches of United States corporations. The treaty generally allows the United Kingdom to tax such income, but in so doing, the United Kingdom must first allow a credit against its tax for any United States tax paid with respect to the same income. This rule is consistent with our other recent treaties and the OECD model tax treaty.

7. The proposed treaty provides for reciprocal exemption of interest and royalties derived by residents of either country from payers in the other. This exemption is provided in the existing treaty.

8. The proposed treaty provides that residents of one country may be taxed by the other country on capital gains derived from sources in that other country. This is a change from the existing treaty under which such capital gains are exempt.

9. The proposed treaty exempts British residents from the U.S. excise tax on insurance premiums. The exemption is not provided in the present treaty.

GENERAL EXPLANATION

Article 1. Personal scope

The proposed treaty generally applies to residents of the United States and residents of the United Kingdom, with specific exceptions designated in other articles. This follows the OECD model tax treaty and most of our other income tax treaties.

However, corporations which are incorporated in the United States but are managed and controlled in the United Kingdom, and thus residents of both for purposes of the treaty ("dual-resident corporations"), may only claim the benefits of certain provisions (described within in connection with the relevant Articles).

Additionally, the usual savings clause is contained in the proposed treaty is not to affect the taxation by the United States or the United Kingdom of their citizens or residents. The principal exceptions involve the determination of domicile for U.K. tax purposes, the limitations placed on the power of State and local governments to tax corporations controlled by U.K. shareholders, the benefits provided under the foreign tax credit and the nondiscrimination, governmental salaries, teachers, and students provisions.

Article 2. Taxes covered

The proposed treaty generally applies to the U.S. Federal income taxes (including social security taxes) imposed under the Internal Revenue Code and the Federal tax on insurance premiums paid to foreign insurers (Code sec. 4371). In the case of the United Kingdom, it applies to the income tax, the capital gains tax, the corporation tax and the petroleum revenue tax.

The proposed treaty applies to income taxes imposed by political subdivisions or local authorities of the United States and the United Kingdom for purposes of the limitations placed on the conbined reporting method of determining income subject to tax in the case of a corporation controlled by a corporation resident in the other country. In practice, this applies only to States and localities in the United States because the political subdivisions and local authorities in the United Kingdom do not impose income taxes.

In addition the nondiscrimination provisions of the proposed treaty (Article 24) apply for all taxes of each country, including all political subdivisions and local authorities of each country.

Finally, the proposed convention also contains a provision generally found in U.S. income tax treaties to the effect that it will apply to substantially similar taxes which either country may subsequently impose.

Article 3. General definitions

The standard definitions found in most of our income tax treaties are contained in the proposed treaty.

For purposes of the treaty, the term "United States," when used in a geographical sense, includes the States and the District of Columbia. Thus, the treaty does not apply to the possessions of the United States or to Puerto Rico. The term "United Kingdom" means Great Britain and Northern Ireland. The treaty does not apply to the Channel Islands, the Isle of Man, the British colonies, or member-states of the Commonwealth. However, the term "Nationals" of the United Kingdom includes, for purposes of the treaty, all citizens of the United Kingdom and its colonies and, in addition, certain other British subjects from Commonwealth countries.

In addition, the proposed treaty contains a provision which is contained in the more recent U.S. tax treaties, which includes within the definition of the term "United States" the territorial sea of the United States and the continental shelf of the United States insofar as the exploration and exploitation of natural resources on the continental shelf is concerned. A similar definition of the United Kingdom is contained in the proposed treaty. The definition of continental shelf areas is similar to that provided in the Internal Revenue Code. The activity of fishing is not intended to be considered the exploration or exploitation of natural resources of the continental shelf, and thus the definition of continental shelf is not to apply with respect to this activity.

The proposed treaty also contains the standard provision that undefined terms are to have the meaning which they have under the applicable tax laws of the country applying the treaty. Where a term is defined in a different manner by the two countries, the competent authorities of the two countries may establish a common meaning for the term in order to prevent double taxation or to further any other purpose of the treaty.

Article 4. Fiscal residence

The benefits of the proposed treaty are generally available only to residents of the two countries. The proposed treaty defines "resident of the United Kingdom" and "resident of the United States". Generally, the proposed treaty treats as residents of a country individuals who are subject to tax in that country on account of their residence therein. In addition, a set of rules is provided to determine residence in the case of an individual with dual residence. This provision of the proposed convention is based on the fiscal domicile article of the OECD model convention and is similar to the provisions found in other U.S. tax treaties.

An individual whom both countries consider to be a resident according to their general rules for determining residence will be deemed for all purposes of the treaty to be a resident of the country in which he has his permanent home, his center of vital interests (his closest economic and personal relations), his habitual abode, or his citizenship. If the residence of an individual cannot be determined by these tests, applied in the order stated, the competent authorities of the countries will settle the question by mutual agreement. Where an estate or trust (taxable as such) is considered to be a resident by both countries, the competent authorities may settle the issue by mutual agreement.

Paragraph (4) of this Article is a unique transitional provision designed to eliminate a difference in the rules for determining domicile under prior U.K. law as between American women married to U.K.

nationals and American men married to U.K. nationals. Under U.K. law, resident aliens are generally taxed on their worldwide income if they are domiciled in the United Kingdom; but if they are not domiciled there, they are only taxed on their income which they receive in the United Kingdom. Under prior U.K. law, a woman who was a resident of the United Kingdom was considered to be domiciled in the United Kingdom if she was married to a man domiciled in the United Kingdom. A man, however, was entitled to establish on the basis of the facts and circumstances that he was not domiciled in the United Kingdom notwithstanding the fact that he was married to a U.K. domiciliary. In order to eliminate this difference in treatment, the U.K. amended its law in 1973 to provide that any woman married to a U.K. domiciliary after January 1, 1974, may, to the same extent as a man, establish under the facts that she is not a U.K. domiciliary and thus not subject to tax on foregin income until it is remitted.

The problem which the treaty provision resolves is that this new rule providing for equivalent treatment of men and women in the determination of domicile under U.K. law does not apply with respect to marriages which occurred prior to 1974. As a transitional rule, U.K. law treats a woman married before 1974 as retaining her husband's domicile. The proposed treaty (as modified by the second Protocol) extends the rule providing equivalent treatment to American women married before 1974 to U.K. domiciliaries by providing that marriages before 1974 of women who are U.S. citizens and men domiciled in the United Kingdom shall be deemed to have taken place on January 1, 1974, for purposes of determining domicile for U.K. tax purposes.

Under the existing treaty, the problem of the domicile of U.S. citizens married to U.K. domiciliaries did not arise because the U.K. courts interpreted the convention as barring the U.K. from taxing U.S. citizens domiciled in the U.K. and, accordingly, the question of domicile was moot. However, the question arises under the proposed treaty because the treaty makes clear that the United Kingdom may tax U.S. citizens domiciled in the United Kingdom on income from U.S. sources (subject to a credit for U.S. taxes paid) once the existing convention ceases to apply to such income (April 6, 1976).

A special rule is provided for cases where income eligible for treaty relief in one country is taxable to a resident of the other country only if, and to the extent that, it is remitted to or received by that person. In certain cases, individuals who are residents of the United Kingdom are not taxable on foreign source investment income, unless it is remitted to or received by them in the United Kingdom. If such income were received in the United States and accumulated by the taxpayer, a United Kingdom resident may not be subject to U.K. tax on that income. If the reductions in U.S. tax rate or exemptions from U.S. tax were to apply to those items of income, the United States would be foregoing tax where double taxation does not in fact occur. Thus, this paragraph provides that if under the law in the other country income would only be taxed on a remittance basis, then any reduced rates of tax (e.g., as provided by Article 10 (Dividends)), or relief from taxation (e.g., Articles 7 (Business Profits) and 8 (Shipping and Air Transport), 11 (Interest), or 12 (Royalties)) provided by this treaty shall apply only to the extent that the income is remitted to or received by the person in the year in which it accrues to the benefit

of that taxpayer. This rule applies to all persons, including individuals, corporations, partnerships, and trusts or estates. A similar provision is contained in the existing treaty.

Article 5. Definition of permanent establishment

The proposed treaty contains a definition of permanent establishment which follows the pattern of the OECD model tax treaty and other recent U.S. income tax treaties. The permanent establishment concept is one of the basic devices used in income tax treaties to avoid double taxation. Generally, a resident of one country is not taxable on its business profits by the other country unless those profits are attributable to a permanent establishment of the resident in the other country. In addition, the permanent establishment concept is used to determine whether reduced rates of, or exemptions from, tax provided for dividends, interest, and royalties are applicable.

In general, a fixed place of business through which a resident of one country engages in industrial or commercial activities in the other country is considered a permanent establishment. This includes a branch, an office, a factory, a workshop, a mine, oil or gas well, quarry, or other place of extraction of natural resources, and any building or construction or installation project which exists for more than 12 months.

This general rule is modified to provide that a fixed place of business which is used for any or all of a number of specified activities will not constitute a permanent establishment. These activities include, among others, the use of facilities for storing, displaying, or delivering merchandise belonging to the resident, the maintenance of a stock of goods belonging to the resident for purposes of storage, display, delivery, or processing by another person, and the purchase of goods or collection of information for the resident.

A resident of one country will be deemed to have a permanent establishment in the other country if it maintains an agent in the other country who has, and habitually exercises, a general contracting authority (other than for the purchase of merchandise) in that other country. The proposed treaty contains the usual provision that the agency rule will not apply if the agent is a broker, general commission agent, or other independent agent acting in the ordinary course of its business.

The fact that a corporation which is a resident of one country controls (or is controlled by) a corporation which is a resident of the other country or which carries on business in the other country shall not of itself cause the latter corporation to be treated as a permanent establishment of the country of the parent's residence.

Article 6. Income from immovable (real) property

The proposed treaty provides that income from immovable property, including income from agriculture or forestry, may be taxed in the country where the property is located. This rule does not preclude the country of residency from taxing the income, but only confirms that the country where the property is located has the primary jurisdiction to tax the income whether or not the income is derived through a permanent establishment.

Immovable property is to be defined under the laws of the country where the property is located. Generally, the term refers to real prop-

erty for purposes of United States and United Kingdom law. Income from real property includes income from use or renting, but it does not include capital gains on the sale, exchange, or other disposition of real property. Ships, boats, and aircraft are not considered to be immovable property.

Article 7. Business profits

Under the proposed treaty, business profits of a resident of one country are taxable in the other country only to the extent they are attributable to a permanent establishment which the resident has in the other country. The business profits provisions are substantially the same as the provisions in the existing treaty and in the OECD model tax treaty.

In computing the taxable business profits, all expenses, wherever incurred, which are reasonably connected with the business profits are allowed as deductions. These expenses include a reasonable allocation of executive and general administrative expenses, research and development expenses, interest, and other expenses incurred for the enterprise as a whole (or the part which includes the permanent establishment). However, in determining the amount of the deduction for expenses incurred by the head office, the deduction generally will be limited to the expense incurred without including a profit element for the head office.

Profits will not be attributed to a permanent establishment merely because of the purchase of goods or merchandise by that permanent establishment for the account of the enterprise. Thus, for example, where a permanent establishment purchases goods for its head office, the business profits attributed to the permanent establishment with respect to its other activities will not be increased by a profit element on the purchasing.

The profits of a permanent establishment are to be determined on an arm's-length basis. Thus, there is to be attributed to it the industrial or commercial profits which would reasonably be expected to have been derived by it if it were an independent entity engaged in the same or similar activities under the same or similar conditions and dealing at arm's-length with the resident of which it is a permanent establishment. In addition, business profits are to be computed on a consistent basis from year to year.

The proposed treaty sets forth examples of types of income which are considered business profits. It follows the approach of our other recent treaties and the Internal Revenue Code by including within business profits investment income which is effectively connected with the permanent establishment. Personal services income earned by an employee is excluded from business profits.

Article 8. Shipping and air transport

The proposed treaty (as modified by the protocol of August 31, 1976) [1] provides that income derived by an enterprise of the United States from the operation in international traffic of ships or aircraft is exempt from United Kingdom tax. Income derived by an enterprise of the United Kingdom from the operation in international

[1] The treaty as initially negotiated included a registery test under which the exemption applied only to income of U.S. enterprises from the operation of ships and aircraft registered in the United States and income of British enterprises from the operation of ships and aircraft registered in the United Kingdom.

traffic of ships or aircraft is exempt from United States tax. These exemptions apply regardless of where the ships or aircraft are registered. The exemption provided in the treaty for U.S. and U.K. residents is broader than the exemption customarily provided in U.S. tax treaties (including the existing U.S.-U.K. tax treaty) under which shipping and air transport income of a resident of one country is exempt by the other only if the ships and aircraft are registered in the first country.

Income from the operation in international traffic of ships or aircraft includes the rental income on a bareboat basis of ships or aircraft operated in international traffic if the rental income is incidental to income from the actual operation of ships or aircraft in international traffic. For example, this rule permits an airline of one country which has excess equipment during certain periods to lease that excess equipment during those periods to an airline of the other country. In such a case the rental income of the lessor is exempt from tax in the other country, whether or not the other airline uses the aircraft in international traffic.

The proposed treaty provides also that income derived by a U.S. enterprise from the use, maintenance, and lease of containers (including trailers and related equipment for the inland transport of containers) used for the transportation of goods or merchandise may not be taxed by the United Kingdom unless the goods or merchandise are transported solely between places within the United Kingdom. Such income derived by U.K. enterprises is similarly exempt from U.S. tax unless the transportation is solely between places within the United States.

Under the proposed treaty, the provisions relating to the taxation of shipping and air transport apply also to profits derived by U.S. or U.K. enterprises from the participation in a pool, a joint business, or an international operating agency.

The proposed treaty also provides that gains of a U.S. enterprise on the sale or disposition of ships, aircraft or containers owned by the U.S. enterprise shall only be taxable by the United Kingdom if under the treaty the income from the ships, aircraft or containers may be taxable by the United Kingdom. Such gains received by U.K. enterprises are similarly not subject to tax by the United States if the income from the disposed ship, aircraft or container is not subject to U.S. tax.

The proposed treaty also exempts from U.K. tax any income derived by a U.S. citizen who is not a resident of the United Kingdom, or by a U.S. corporation (including a dual resident corporation), from the operation of ships or aircraft registered in the United States. This exemption from U.K. tax applies even if the ships or aircraft are operated solely within the United Kingdom. This provision confirms that the United Kingdom grants to U.S. citizens and corporations (including dual resident corporations) the equivalent exemption required in order for the shipping and aircraft income of U.K. nationals and corporations to be exempt from U.S. tax under Code sections 872(b) and 883. As contrasted with the general shipping and aircraft exemption contained in the proposed treaty, this exemption applies only to income derived from the operation of ships or aircraft registered in the United States.

Except as set forth in the previous paragraph, the shipping and air transport provisions are subject to the savings clause. Therefore the United States may, without regard to this Article, tax income derived by U.K. residents from shipping or air transport, or from the use of rental of containers, if the U.K. residents are citizens of the United States. Similarly, the United Kingdom can tax shipping and air transport income derived by U.K. nationals resident in the United States.

Article 9. Associated enterprises

The proposed treaty like most other U.S. tax treaties contains a provision similar to the Internal Revenue Code (sec. 482) which recognizes the right of each country to make an allocation of income in the case of transactions between related persons, if an allocation is necessary to reflect the conditions and arrangements which would have been made between unrelated persons.

It is anticipated that when a redetermination has been made by one country with respect to the income of a related person, the other country will attempt to reach an agreement with the first country in connection with the redetermination, and if it agrees with the redetermination, it will make a corresponding adjustment to the income of the other person.

The proposed treaty also contains a new provision, not found in other United States treaties or the OECD model tax treaty, which limits the methods by which the United States, the United Kingdom, and political subdivisions and local authorities of each country may tax enterprises of the other country (or enterprises which are directly or indirectly controlled by enterprises of the other country). The proposed treaty provides that in determining the tax liability of such an enterprise doing business within their respective jurisdictions, the United States, the United Kingdom and their political subdivisions and local authorities may not take into account the income, deductions, receipts, or outgoings of a related enterprise of the other country or of any third country.

This provision is intended to apply to those States of the United States which, in determining the amount of income of a business operating within the State which is to be apportioned to that State for income tax purposes, require combined reporting of all related business operations (including related business operations of affiliated U.S. and foreign corporations). The governments of the United Kingdom and the United States do not apportion income between jurisdictions under this method but rather allocate income between related enterprises under arm's-length principles as is specified in other paragraphs of this Article. In addition, the political subdivisions and local authorities of the United Kingdom do not impose income taxes. Consequently, this provision's only application is to limit the combined reporting method used by certain States of the United States.

In determining what business income is earned within a State and thus subject to income tax by that State, all States imposing an income tax use some type of apportionment system. An apportionment system is necessary because of the difficulties of attempting to account separately for business income in any State where the activities of a single business are carried on beyond the borders of that one State. In most States this business income is apportioned between the State and other

jurisdictions according to a basic three-factor formula (or some variation of the formula) under which total business income is multiplied by the average ratio of sales, payroll, and property values within the State to total sales, payroll, and property values associated with the business. This type of apportionment, when applied to a single business of one corporation, is called the "unitary method" of apportionment and is used by most States which have a corporate income tax.

However, some States have adopted "combined reporting" requirements, which extend the unitary method to corporations related to the corporation doing business within the State (subsidiaries, parent corporations, or brother-sister corporations) where the activities of the related corporations together constitute a unitary business. For example, if a U.S. manufacturing company operating in a State requiring combined reporting owns a British subsidiary which sells in the United Kingdom the products manufactured by the U.S. parent, the income subject to tax in that State would be determined under the combined reporting method by applying the average ratio of the sales, payroll, and property values in the State to total sales, payroll, and property values of both corporations in both countries and multiply these average ratios against the combined worldwide income of the two corporations.

The treaty provision prevents a State from extending the unitary method through this combined reporting system to related foreign enterprises where the enterprise doing business in the State is either a British enterprise or is controlled directly or indirectly by a British enterprise. Thus, for example, if a U.S. branch of a British corporation does business in a State, that State cannot apply the unitary method to combine the income (and sales, payroll, and property) of any related foreign enterprises (from the United Kingdom or any third country) with those of that British corporation in determining the income of its U.S. branch which is taxable by that State. However, that State may take into account the income and assets of any other branches of that corporation, wherever located, because a corporation is considered to be a single enterprise regardless of how many branches it has. Alternatively, if the British corporation does not do business in the State, but has a U.S. subsidiary (or any corporation which it directly or indirectly controls) doing business in the State, that State, in determining the taxable income of that U.S. subsidiary, cannot apply combined reporting requirements to include in its three-factor apportionment formula the income (and the sales, payroll, and property values) of the British parent corporation or any other related foreign enterprises. Of course, in either situation described above, the State may take into account the income and assets of any related U.S. corporations.

This provision would have a significant impact on those States where combined reporting is frequently required. California, Oregon, and Alaska have traditionally been the primary States requiring the use of combined reporting. Certain other State governments have also indicated that combined reporting is at times required in their States, or that they may in the future require this type of reporting at least in some cases.

There are two additional exceptions to the combined reporting limitation. First, if the British enterprise is a corporation which is itself directly or indirectly controlled by residents of the United States

(Code sec. 957) or of any third country, the limitation does not apply. In addition, in computing the tax liability of any U.S. subsidiary (or other enterprise) resident in the State which is controlled by a British enterprise, the three-factor formula may, notwithstanding the general prohibition, be applied to any related foreign enterprise to the extent that the U.S. subsidiary owns, directly or indirectly, the capital of the related foreign enterprise.

For purposes of the proposed treaty, an enterprise is related to another enterprise if either enterprise directly or indirectly controls the other, or if any third person or persons (related to each other or acting together) control both. The technical explanation prepared by the Treasury states that the term control is not limited to the ownership of the capital of an enterprise, and it includes any kind of control, whether or not legally enforceable, however exercised or exercisable.

Article 10. Dividends

The proposed treaty contains a new and complex set of provisions with respect to the taxation of dividends which in a number of respects are substantially different from the existing tax treaty with the United Kingdom and from other U.S. tax treaties. In 1973, the United Kingdom introduced a new system of corporate taxation which in part integrates corporate income tax with the individual income tax. The integrated tax system of the United Kingdom differs substantially from the system of separate corporate taxation used by the United States (under which dividends received by shareholders are generally taxed without regard to the taxes paid by the distributing corporation). The new provisions contained in the proposed treaty relating to dividends are designed to accommodate the problems which are presented by the interaction of the differing U.K. and U.S. systems.

Under the existing treaty, neither country can tax dividends paid by resident corporations to shareholders resident in the other country at a rate exceeding 15 percent of the gross amount of the dividend.[1] However, the treaty provides that as long as the U.K. integrated system applies the general 15 percent withholding tax is to be replaced by the refund withholding system described below.

Under the new system adopted by the United Kingdom, a special "Advance Corporation Tax," or "ACT," is collected from a U.K. corporation on any distribution to its shareholders in an amount equal to 35/65 of the amount of the distribution. At the U.K. corporate level, ACT payments can, within certain limits, be credited against the regular U.K. 52-percent corporate income tax (the "mainstream tax"), if any, paid by the corporation in the year of the distribution. If no mainstream tax is paid, the ACT can be carried back two years and carried forward indefinitely to be credited against mainstream tax otherwise payable in those years. Where the dividend is out of taxable income and the ACT is fully creditable, the aggregate 52-percent tax paid by the corporation is not affected by the payment of a dividend because the ACT payment with respect to the dividend is fully offset by the reduced mainstream tax.

[1] The proposed treaty provides that in the event that the United Kingdom modifies its current system of taxation and ceases to allow a shareholder credit to its residents, then dividends will be treated as they are under the existing treaty, and the withholding taxes of both the United States and the United Kingdom will be limited to 15 percent on dividends paid to residents of the other country.

In addition to being allowed as a credit against the distributing corporation's mainstream tax, the amount of ACT paid by the corporation is also refunded to U.K. shareholders receiving the dividends either through a credit against the shareholder's U.K. income tax liability or through a cash refund to the extent that the ACT payment exceeds the shareholder's income tax liability. However, the dividend subject to tax is "grossed up" by the amount of ACT paid by the corporation; that is, the U.K. shareholder is required to include in taxable income the amount of ACT credited or refunded to him as well as the amount of the cash dividend. For example, if a U.K. corporation pays a cash dividend of $65, it must also pay ACT of $35 (which it may credit against the mainstream tax). The shareholder includes in income $100 (the $65 distributed and the $35 of ACT) and receives a tax credit or refund of $35.

In the absence of a tax treaty, the ACT is not refunded to nonresident aliens of the United Kingdom. Thus, under the new U.K. hybrid system, there is a higher tax burden imposed on dividends to nonresident shareholders than is imposed on U.K. resident shareholders; the unrefunded ACT can thus be viewed as an additional U.K. tax at the corporate level on dividend distributions to foreign shareholders. On amounts distributed to U.K. resident shareholders, the aggregate U.K. tax burden (the tax paid by the corporation reduced by the shareholder credit) ranges from zero to 26 percent (the effective rate depends upon the extent to which the distribution is out of taxable income compared to the extent it is derived from nontaxable earnings or capital). Since nonresident shareholders from nontreaty countries do not receive the refundable shareholder tax credit allowed U.K. resident shareholders, the effective U.K. tax burden on distributions to them ranges from 35 percent to 52 percent. By not making the shareholder credit available to nonresidents, the U.K. hybrid integration system has substantially the same effect with respect to dividends as if the U.K. imposed corporate income tax of up to 52 percent on retained earnings, up to 26 percent on earnings distributed as dividends, and a 35-percent dividend withholding tax.

U.S. direct corporate investors.—Under the proposed treaty, separate rules are provided for the taxation of dividends to shareholders which are U.S. corporations owning at least 10 percent of the distributing U.K. corporation's stock which are different from the rules applicable in the case of other U.S. shareholders (because only corporate shareholders owning 10 percent of the stock are entitled to indirect foreign tax credits for U.K. income taxes paid by the U.K. corporation paying the dividend).[2]

In the case of a U.S. corporation which is a direct investor in a U.K. corporation, the proposed treaty provides that the U.S. corporation is entitled to a payment from the United Kingdom of an amount equal to one-half of the ACT paid with respect to the dividend, subject to a deduction withheld from the payment of up to 5 percent of the combined cash dividend plus the refunded one-half of the ACT.

To illustrate by example, on a dividend of $65 paid by a U.K. corporation to a U.S. direct corporate investor, the U.K. corporation pays

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[2] As contrasted with the rules applicable to U.K. direct corporate investors in U.S. corporations (discussed below), a U.S. corporation will be considered to be a direct investor where it, together with any related corporations, owns a 10-percent stock interest in the U.K. corporation.

ACT of $35 to the U.K. Treasury, which in turn refunds approximately $13.50 to the U.S. shareholder—the amount equal to one-half of the ACT paid ($17.50) reduced by 5 percent of the sum of the cash dividend and one-half of the ACT (roughly $4, or 5 percent of the sum of $65 plus $17.50). Thus, the proposed treaty requires that the U.K. refund to direct U.S. corporate investors approximately 40 percent (13.5/35) of the ACT imposed on the corporation. The refund provided for in the proposed treaty reduces the maximum effective U.K. Tax burden on distributions to these direct U.S. corporate investors from 52 percent to 42 percent, and the minimum effective U.K. rate from 35 percent to 21.5 percent. Alternatively, the refund can be viewed as reducing the additional U.K. tax imposed on distributions to nonresidents (that is, the unrefunded ACT) from 35 percent to 21.5 percent.

The United Kingdom does not generally impose any withholding tax on nonresident shareholders under its new hybrid system. However, it does impose a withholding tax in those situations where it has agreed in tax treaties to refund the ACT to residents of the other treaty country. In any case where the U.K. corporation pays out some but not all of its after-tax income as dividends, the 5-percent withholding tax has the effect of slightly increasing the foreign tax which is treated as paid by the shareholder on the distribution and thus increasing the U.S. foreign tax credit allowed on the distribution.

U.S. individuals and portfolio investors.—Different rules are provided with respect to dividends from U.K. corporations to U.S. shareholders who are not corporations owning 10 percent of the U.K. corporation's stock (and thus are not entitled to a U.S. indirect foreign tax credit with respect to the taxes paid by the U.K. corporation). In these other cases, the proposed treaty provides for a payment to the U.S. shareholder by the U.K. Treasury of the full amount of the ACT paid by the U.K. corporation with respect to the dividend. However, this refund is reduced by a 15 percent withholding tax on the sum of the dividend and the ACT paid. To illustrate by example, on a dividend of $65 paid by a U.K. corporation to a U.S. resident individual or to a corporate portfolio investor, the U.K. corporation pays ACT of $35 to the U.K. Treasury, which in turn pays over to the U.S. shareholder $20—the excess of the ACT paid ($35) over 15 percent of the sum of the cash dividend and the ACT ($15, or 15 percent of the sum of $65 plus $35). Thus, of $100 paid out by the U.K. corporation, $85 is received by the U.S. shareholder and $15 is retained by the U.K. Treasury.

As discussed in further detail in connection with the provision dealing with the foreign tax credit (*Article 23. Elimination of double taxation*), the proposed treaty also provides that the full $100 is to be treated for U.S. foreign tax credit purposes as a dividend and that the $15 not refunded is to be treated as if it were a U.K. withholding tax imposed upon the shareholder. As indicated above, the United Kingdom does not generally impose a withholding tax except where it has agreed to refund ACT pursuant to a tax treaty. The withholding tax for shareholders who are U.S. residents has the effect of treating the ACT not refunded will be treated as a tax paid by the shareholder receiving the distribution (rather than the corporation paying the dividend), thereby giving the shareholder a foreign tax credit against his U.S. tax liability on the dividend.

U.K. shareholders.—With respect to dividends paid by U.S. corporations, the withholding tax which the United States may impose on U.K. resident shareholders depends upon whether or not they are direct corporate investors. In the case of dividends paid to U.K. corporations owning at least 10 percent of the distributing U.S. corporation's stock, the otherwise applicable 30-percent U.S. withholding tax is reduced to 5 percent. In the case of dividends paid to all other U.K. shareholders, the U.S. withholding rate is only reduced to 15 percent.

As a result of these provisions, the maximum combined effective rate of tax (mainstream corporate tax and ACT) imposed by the U.K. on corporate earnings distributed to U.S. direct corporate shareholders is reduced from 52 percent to approximately 42 percent (a 52-percent corporate burden reduced by an ACT refund paid to the shareholders). In contrast, the maximum combined effective rate of U.S. tax (corporate tax and withholding tax) on U.K. direct corporate investors is reduced by the proposed treaty from approximately 63 percent (48 percent plus a 30 percent withholding tax on the remainder left for distribution) to approximately 51.5 percent (48 percent plus 5 percent of the remainder left for distribution). The combined effective U.K. rate on U.S. resident individuals and portfolio investors is reduced from 52 percent to approximately 37 percent, while the U.S. effective rate on U.K. resident individuals and portfolio investors is reduced from 63 percent to approximately 55.5 percent.

Special rules and exceptions.—The dividend provisions also do not apply in two circumstances where tax avoidance may occur. First, where a resident of either country owns 10 percent or more of the shares of a corporation with respect to which dividends are paid, these provisions do not apply to the extent that the dividends are paid out of income or profits which the corporation earned or received in a period ending a year or more before the date on which the shareholder became the owner of 10 percent or more of the corporation's stock. This rule is designed to prevent transactions where a 10-percent stock interest is acquired in order to obtain a distribution of the past earnings of a corporation at a reduced rate of tax.

A second rule is designed to deny the benefits of the dividend provisions to U.S. tax-exempt organizations if the dividends are received in circumstances where they would have been subject to U.K. tax if they had been received by an exempt organization of the United Kingdom. Under United Kingdom law, if a resident of the United Kingdom sells securities to a tax-exempt organization immediately before the payment of dividends, the organization will be taxable on the dividends paid in respect to the securities if the transaction was designed to accord the initial seller a preferential rate of tax on his sale. This rule is contained in the existing treaty.

These two tax avoidance rules shall not apply if the beneficial owner of the shares satisfies the competent authority of the taxing country that the shares were acquired for bona fide commercial purposes and not to secure the benefits of the proposed convention.

In addition to the above new rules added to the treaty to take into account the U.K. integrated tax system, a number of other provisions were included which are generally similar to those in the existing British treaty or in the OECD model treaty.

The above provisions relating to dividends do not apply to dividends received by U.S. residents who carry on business through a permanent

establishment in the United Kingdom, or who perform independent services from a fixed base in the United Kingdom, where the dividends are effectively connected with the permanent establishment or fixed base. Similarly, the provisions do not apply to dividends received by U.K. residents who carry on business through a permanent establishment in the United States, or who perform independent personal services from a fixed base in the United States, where the dividends are effectively connected with the permanent establishment or fixed base. In such situations, the provisions relating to business profits (Article 7), independent personal services (Article 14), or artists and athletes (Article 17), as the case may be, shall apply.

As in the case of most U.S. tax treaties and the OECD model tax treaty, the proposed treaty contains a general limitation on the taxation of dividends paid by corporations which are residents of the other country. Under this provision, the U.K. may not impose any taxes on the dividends paid by a U.S. corporation except where such dividends are paid to U.K. residents or where the dividends are effectively connected with a permanent establishment or fixed base in the United Kingdom. Similarly, the United States may not impose any tax on dividends paid by a U.K. corporation except where the dividends are paid to a resident or citizen of the United States or where the dividends are effectively connected with a permanent establishment or fixed base situated in the United States. These exemptions apply even if the dividends consist wholly or partly of profits or income arising in the taxing jurisdiction.

The proposed treaty also provides that a U.K. corporation shall be exempted from the U.S. accumulated earnings tax if U.K. resident individuals (other than U.S. citizens) control, directly or indirectly, throughout the last half of the taxable year, more than 50 percent of the entire voting power of the corporation. This provision is contained in the existing tax treaty with the United Kingdom.

Article 11. Interest

Under the proposed treaty, interest derived by a resident of one country (other than a citizen of the other country) from sources within the other country is exempt from tax in the source country. This exemption does not apply if the recipient has a permanent establishment or fixed base in the source country and the interest is effectively connected with the permanent establishment or fixed base. If the interest is effectively connected with a permanent establishment or fixed base, then it will be taxed under the provisions of the proposed treaty dealing with business profits (Article 8), independent personal services (Article 14), or artists and athletes (Article 17), as the case may be. This treatment generally conforms to that provided by other recent U.S. tax treaties and the OECD model tax treaty.

The exemption from U.K. tax under this article will not apply if the recipient of the interest is exempt from tax on such income in the United States and the recipient sells or makes a contract to sell the holding from which such interest is derived within three months after the date the recipient acquired such holding.

A definition of interest is provided which is also substantially identical to that found in the OECD model tax treaty and other recent U.S. income tax treaties. In situations where the payor and recipient

are related, the proposed treaty limits the amount treated as interest to that which would have been paid had they not been related.

Interest paid by a resident of one country, regardless of where it derives its income, to a person other than a resident of the other country (and, in the case of interest paid by a U.K. corporation, to a person other than a U.S. citizen) will be exempt from tax by the other country. However, this rule is inapplicable if the interest is effectively connected with a permanent establishment or fixed base which the recipient has in the other country.

Paragraph (7) of this article is carried over from the existing treaty. Under U.K. domestic law, interest payments by U.K. corporations to non-U.K. corporations which have 75 percent or more control, directly or indirectly, of the U.S. corporation are treated as dividends rather than as deductible interest. This paragraph provides (in reciprocal terms) that this rule shall not apply where the interest payment is to a U.S. resident. A dual resident corporation may claim the benefits of the provision with respect to interest payments it makes. However, the exemption does not apply to the interest paid to a U.S. corporation if more than 50 percent of the voting power of the U.S. corporation is directly or indirectly controlled by residents of the United Kingdom.

Paragraph (8) provides that the exemption from United Kingdom tax under paragraph (2) of this Article will not apply if the recipient of the interest is exempt from tax on such income in the United States and the recipient sells or makes a contract to sell the holding from which such interest is derived within three months after the date the recipient acquired such holding.

Article 12. Royalties

Under the proposed treaty, industrial and artistic royalties derived from one country by a resident of the other country are exempt from tax in the source country. The exemption does not apply if the recipient has a permanent establishment in the source country or performs independent personal services through a fixed base in the source country, and the royalties are effectively connected with the permanent establishment or fixed base. If the royalty is effectively connected with a permanent establishment or fixed base, then it will be taxed under the provisions relating to business profits (Article 8), independent personal services (Article 14), or artists and athletes (Article 17), as the case may be. This treatment of royalties is substantially identical to that provided in the OECD model convention.

The proposed treaty does not include film royalties within the scope of the royalties article. Instead, they are treated as business profits and, accordingly, are exempt from tax unless they are attributable to a permanent establishment which the recipient maintains in the source country.

As in the case of the interest provision, the royalty provision does not apply to that part of a royalty paid to a related person which is considered excessive.

Article 13. Capital gains

The proposed treaty provides that, except as provided in Article 8 (Shipping and air transport), capital gains are taxable in accordance with the domestic laws of each country. This rule applies to the

existing laws of the United States and the United Kingdom respecting the taxation of capital gains and revisions of those laws subsequent to the effective date of the proposed treaty. Whether an item of income constitutes capital gains shall be determined under the laws of the country seeking to tax those gains.

Under current U.S. law, nonresident alien individuals are generally not taxable in the United States on their U.S. source capital gains unless (1) they are present in the United States for 183 days or more during a taxable year or (2) the gains are effectively connected with the conduct of a U.S. trade or business. Foreign corporations generally are taxable in the United States only on capital gains which are effectively connected with the conduct of a U.S. trade or business.

The representatives of the United States and the United Kingdom are to consult with each other upon the enactment or the proposed enactment by either country of any laws which substantially change the manner in which capital gains derived by nonresidents are taxed.

Article 14. Independent personal services

Under the proposed treaty, income from the performance of independent personal services (i.e., services performed as an independent contractor rather than as an employee) in one country by a resident of the other country is exempt from tax in the country where the services are performed unless (1) the person performing the personal service is present in the source country for 183 or more days during the taxable year and the income is attributable to services performed in that country, or (2) the person maintains a fixed base regularly available to him in the source country and such income is attributable to the fixed base.

Article 15. Dependent personal services

Under the proposed treaty, income from services performed as an employee in one country (the source country) by a resident of the other country will not be taxable in the source country if three requirements are met: (1) the individual is present in the source country for no more than 183 days during the taxable year; (2) compensation is not paid by, or on behalf of, an employer who is a resident of the source country; and (3) the compensation is not borne by a permanent establishment of the employer in the source country. The treatment of dependent personal services is the same as that provided in the OECD model tax treaty.

Compensation derived by an employee from the performance of personal services as a member of the regular complement of a ship or aircraft operated in international traffic by a resident of one country is exempt from tax by the other country.

Article 16. Investment or holding companies

The proposed treaty contains a provision which denies the benefits of the dividends, interest, and royalties articles to a corporation which is entitled in its country of residence to special tax benefits resulting in a substantially lower tax on those types of income than the tax generally imposed on corporate profits by that country, if more than 25 percent of the capital of the corporation is owned by individuals who are not residents of that country or U.S. citizens. A similar provision is contained in several recent U.S. tax treaties (Iceland, Norway, and Trinidad and Tobago). The OECD model tax treaty does not have a comparable provision.

This article also provides that a corporation which is a resident of the United States shall not be entitled to the benefits of the articles relating to dividends, interest or royalties arising in the United Kingdom where more than 80 percent of its gross income (including such dividends, interest, or royalties) is derived from sources outside of the United States. This limitation does not apply if more than 75 percent of the capital of the corporation is owned directly or indirectly by individuals who are U.S. citizens or residents.

Neither of these limitations apply to a U.S. corporation if 75 percent or more of its capital is directly or indirectly owned: (a) by another U.S. corporation which receives 20 percent or more of its gross income from sources within the United States; (b) by a foreign corporation which would not be treated as a close company under U.K. law; or (c) by a corporation, resident in the United Kingdom, more than 50 percent of the voting power of which is controlled directly or indirectly by individuals who are residents of the United Kingdom.

The purpose of the first limitation is to prevent residents of third countries from using a corporation in one treaty country, which is preferentially taxed in that country, to obtain the tax benefits in the other treaty country which the proposed treaty provides for dividends, interest, and royalties derived from that other country. This accords with the purpose of an income tax treaty between two countries to lessen or eliminate the amount of double taxation of income derived from sources within one country by a resident of the other country. At the present time, neither the United Kingdom nor the United States grants to investment or holding companies the type of tax benefits with respect to dividends, interest or royalties which would make this limitation applicable. Thus, it will have effect only if the United Kingdom or the United States should subsequently enact special tax measures granting preferential tax treatment to dividends, interest or royalties received by an investment or holding company.

The second limitation is intended to prevent the use of U.S. corporations by residents of third countries in order to take advantage of the reduced rates of tax or exemptions from tax granted by the United Kingdom on dividends, interest and royalties paid to residents (including corporations) of the United States. Generally, interest and dividends paid by U.S. corporations to nonresidents of the United States are not subject to tax by the United States if more than 80 percent of the corporation's gross income is from sources outside the United States (sec. 862). Accordingly, were it not for this provision, a resident of a third country could establish a U.S. corporation solely to derive interest or dividends from the United Kingdom subject to the reduced rates and refunds allowed by the treaty. While such income would be subject to normal corporate taxes in the United States, the corporation's dividends or interest to the third country residents would be exempt from U.S. withholding taxes. This limitation prevents this abuse where the 25 percent or more of the capital of the corporation is owned by individuals who are not U.S. citizens or residents. Since the purpose of this provision is only to prevent the use of U.S. corporations in cases where their income would otherwise qualify for reduced withholding rates in the United Kingdom and their distributions to third country residents would not attract U.S. withholding taxes, exceptions to the rule are given where that corporation is owned

by another U.S. corporation whose distributions would attract U.S. withholding taxes; where that corporation is owned by a corporation which is not a close company under U.K. law; and where the corporation is owned by a corporation resident in the United Kingdom 50 percent or more of the voting power of which is controlled by U.K. resident individuals.

Article 17. Artists and athletes

The proposed treaty contains a separate set of rules which govern the taxation of income earned by public entertainers (such as theater, motion picture, radio or television artists and musicians) and athletes. The proposed treaty provides that, notwithstanding the other provisions dealing with the taxation of personal services (Articles 15 and 16), each country may tax nonresident entertainers or athletes on the income from their personal services performed in the country during any year in which their gross receipts (including reimbursed expenses or expenses borne on their behalf) for services performed in that country during that year exceed $15,000. Thus, highly paid entertainers and athletes will be taxable by the country in which they perform, regardless of the period of time spent in that country. However, as in the case of the other provisions dealing with personal services income, this provision does not bar the country of residence or citizenship from also taxing that income (subject to a foreign tax credit).

In addition, the proposed treaty provides that where income in respect of personal services performed by an entertainer or athlete is paid not to the entertainer or athlete but rather to another person or entity, that income will be taxable by the country in which the services are performed in any situation where the entertainer or athlete shares directly or indirectly in the profits of the person or entity receiving the income. For this purpose, participation in the profits of the recipient of the income includes the receipt of deferred compensation, bonuses, fees, dividends, partnership distributions, or other distributions.

This provision represents a recent modification in the U.S. treaty negotiation position. It prevents highly paid performers and athletes from avoiding tax in the country in which they perform by routing the compensation for their services through a third person such as a personal holding company.

Article 18. Private pension, and annuities, and alimony

Under the proposed treaty, private pensions and annuities derived by residents of the United States are exempt from tax by the United Kingdom, and private pensions and annuities derived by residents of the United Kingdom are exempt from tax by the United States. In addition, alimony paid to a resident of either country is exempt from tax by the other country.

Article 19. Government service

Under the proposed treaty, compensation, other than a pension, paid by the Government of either country to an individual for services rendered to that country is generally taxable only in that country. However, such compensation is taxable only in the country in which the services are being performed if the recipient is a resident national of that country or is a resident solely for the purpose of performing the services. This provision does not apply to compensation received

for services performed for political subdivisions and local authorities. The provision generally follows the OECD model tax treaty, and it is similar to the provision in the existing U.S.-U.K. tax treaty.

Any pension paid by either country, or a political subdivision or a local authority thereof, to any individual in respect of services rendered to that country or subdivision or local authority is generally taxable only in that country. However, a pension is taxable only in the other country if the recipient is both a national of and a resident of that other country.

These provisions do not apply if the services are rendered in connection with any business carried on by or on behalf of either country or a political subdivision or local authority. In such cases, the provisions of Articles 14 (Independent Personal Services), 15 (Dependent Personal Services), 17 (Artists and Athletes), and 18 (Pensions) apply, as the case may be. In addition, these provisions do not apply to an individual who acquires immigrant status in the country in which he performs the services or receives the pension. See paragraphs (3) and (4)(b) of Article 1 (Personal Scope).

Article 20. Teachers

The proposed treaty provides that a professor or teacher who is a resident of one country will be exempt from tax in the other country on income from teaching or from engaging in research at an educational institution in the host country if he is present in that other country for a period not exceeding two years. Unlike the present treaty and other U.S. tax treaties, if the two-year period is exceeded, the exemption will be lost retroactively. In addition, the exemption for income from research only applies if the research is undertaken in the public interest and not primarily for the benefit of some other private person or persons.

Article 21. Students and trainees

The treatment afforded students and trainees under the proposed treaty corresponds generally to the existing treaty and to the OECD model tax treaty. Residents of one country who become students or business apprentices in the other country will be exempt from tax in the host country on payments received for their maintenance, education, or training, if they are engaged in a full-time education or training program and the payments are made from sources outside the host country. Payments will be considered to have been made from sources outside of the host country when they are borne by a person who is not a resident of that country. The exemption does not apply to payments to students or business apprentices who are nationals of or residents with immigrant status in the host country.

Article 22. Other income

Items of income not otherwise dealt with in the proposed treaty which are derived by residents of either country shall be taxable only by the country of residence, regardless of the source of the income. That rule, however, does not apply to residents of one country carrying on a business in the other country through a permanent establishment or performing independent personal services in that other country from a fixed base situated therein, where the income paid is effectively connected with the permanent establishment or fixed base. In

such situations, the provisions of Article 7 (Business profits), Article 14 (Independent personal services) or Article 17 (Artists and athletes), as the case may be, shall apply.

However, the Article specifies that each country may continue to tax income paid out of trusts. This provision allows the U.K. to continue to apply its taxes on accumulation and discretionary trusts.

Article 23. Elimination of double taxation

In General.—The proposed treaty contains the general rule contained in many U.S. tax treaties under which the United States agrees that it will continue to allow its U.S. citizens and residents to claim a foreign tax credit (Code sec. 901) against the U.S. tax for the appropriate amount of income taxes paid to the United Kingdom. The proposed treaty also makes the indirect foreign tax credit (Code sec. 902) available where a U.S. corporation receives a dividend from a U.K. corporation in which it has at least a 10-percent ownership interest. In this case, a credit will be allowed for the appropriate amount of tax paid to the United Kingdom by the U.K. corporation with respect to the profits out of which the dividend is paid. The (direct or indirect) credit allowed under the proposed treaty is subject to the limitations and in accordance with the provisions of U.S. law (as it may be amended from time to time without changing the general principle of allowing a foreign tax credit) applicable to the year in question.

The proposed treaty similarly provides that the United Kingdom shall allow a foreign tax credit against its tax for U.S. tax paid on profits or income from sources within the United States. The credit is to be subject to the provisions of U.K. law regarding the allowance of a foreign tax credit as they may be amended from time to time without changing the general principle of allowing a foreign tax credit. In addition, the proposed treaty provides that where a U.K. corporation receives a dividend from a U.S. corporation and the U.K. corporation controls (directly or indirectly) at least 10 percent of the voting power of the U.S. corporation, the United Kingdom is to allow an indirect credit for the U.S. taxes paid by the U.S. corporation in respect of the profits out of which the dividends are paid.

In addition, the proposed treaty sets forth the general rule that income or profits derived by a resident of one country which may, under the proposed treaty, be taxed by the other country shall be deemed to arise from sources within that other country. However, an exception to that rule is provided with respect to residents of the United Kingdom who are U.S. citizens (and thus are taxed by the United States on the basis of citizenship). Under the proposed treaty, the United Kingdom shall not be required in that situation to allow a credit with respect to U.S. tax on income the U.S. citizen earned from sources outside the United States (as determined under the laws of the United Kingdom). Similarly, the United States shall not be required to allow to such U.S. citizens a foreign tax credit for U.K. taxes on income from sources outside the United Kingdom (as determined under the laws of the United States).

The Advance Corporation Tax (the "ACT").—In addition to the general rules providing for the allowance of the foreign tax credit, the proposed treaty also sets forth special rules which govern the man-

ner in which the taxes imposed by the United Kingdom on U.K. corporations (in particular, the ACT) are to be treated for purposes of the U.S. foreign tax credit allowable on dividends paid to U.S. shareholders.

As discussed above in connection with the provisions of the proposed treaty relating to dividends, the United Kingdom has a hybrid corporate tax system which in part integrates the tax imposed on corporations and their shareholders. Under the U.K. system, the effective rate of tax paid by a U.K. corporation depends upon the extent to which it has paid out dividends. The corporation is subject to a "mainstream" corporation tax imposed at a rate of 52 percent. When it makes a distribution to its shareholders, it is subject to an additional tax, the ACT, equal to 35/65 of the distribution. However, since the corporation is entitled to credit the ACT payment against its mainstream tax liability (subject to certain limitations), the ACT payment does not result in an increased tax burden on the corporation except in situations where the U.K. corporation distributes amounts which have not been subject to the mainstream corporate tax (distributions out of earnings in excess of its U.K. taxable income or out of capital.)

In addition to the credit of the ACT allowed against the corporation's mainstream tax, U.K. shareholders are entitled to credit an amount equal to the ACT payment against their U.K. income tax liability on the distribution (the U.K. shareholder receives a cash refund to the extent, if any that the ACT payment by the corporation exceeds the shareholder's tax liability). In the absence of a tax treaty, the ACT is not refunded to nonresident aliens, and the unrefunded ACT results in an actual increased tax burden with respect to dividends paid to nonresidents.

There is some question whether, in the absence of the proposed treaty, the unrefunded ACT would be treated as a creditable income tax for U.S. foreign tax credit purposes. On the one hand, although the unrefunded ACT may be viewed as a foreign tax with respect to income of the U.S. shareholders because it is imposed with respect to dividend income paid to them, it is imposed on the paying U.K. corporation rather than the U.S. shareholder receiving the distribution and thus would not be allowed as a direct income tax credit to the U.S. shareholder. On the other hand, although it is a tax imposed on the paying U.K. corporation, it is not imposed with respect to income of the paying corporation, but rather on all distributions made by the U.K. corporation, whether out of taxable income, out of untaxed earnings, or out of capital.

In the case of dividends paid to U.S. resident shareholders (other than U.S. corporations owning more than 10 percent of the U.K. corporation's stock), the proposed treaty provides (*Article 10. Dividends*) that the United Kingdom is to pay to the U.S. shareholder an amount equal to the amount which would be refunded to U.K. resident shareholders with respect to the distribution. However, the refund to these U.S. shareholders is to be reduced by an amount equal to 15 percent of the sum of the distribution and the full refund which would be paid to U.K. shareholders. For example, on a distribution of $65, U.K. resident shareholders would be allowed a credit of $35. Under the proposed treaty, U.S. shareholders (other than direct corporate investors) would receive a net refund of $20—

the $35 credit allowable to U.K. shareholders less $15 (15 percent of the sum of the $65 distribution and the $35 credit). Since the amount of the refund paid to U.K. shareholders is 35 percent of the sum of the dividend and the refund, the net payment made to these U.S. shareholders ($35 less $15, or 20 percent of that sum) is to be a little more than one-half of the credit allowed to U.K. shareholders (20/35ths).

The proposed treaty provides that for U.S. foreign tax credit purposes the U.S. shareholder is to be treated as having received a dividend equal to the distribution paid plus an amount equal to the full refund payable to U.K. shareholders (*Article 10(2)(a)(iii)*) and that the reduction in the refund payable to U.S. shareholders equal to 15 percent of that grossed-up dividend is to be treated as creditable income tax imposed on the U.S. shareholder (*Article 23(1)(b)*). For example, on a dividend of $65, the U.S. shareholder will receive a net payment from the U.K. Treasury of $20 and will be treated for U.S. foreign tax credit purposes as having received a dividend of $100 ($65 distribution plus $35 credit) from which a $15 creditable income tax has been withheld. The effect of providing for a full 35-percent payment to the U.S. shareholder subject to the special 15-percent reduction is to permit the U.S. shareholder to claim a foreign tax credit for the 15-percent reduction.

In the case of distributions made to U.S. corporations which own at least 10 percent of the voting stock of the distributing U.K. corporations ("direct corporate investors"), the provisions contained in the proposed treaty relating to the U.S. foreign tax credit are more complicated. In the case of distributions to U.S. direct corporate investors, the proposed treaty provides that the U.K. Treasury is to make a payment to U.S. direct corporate shareholders equal to one-half the credit which would be allowed to U.K. resident shareholders. However, the payment from the U.K. Treasury is to be reduced by an amount equal to 5 percent of the sum of the distribution and the payment. To illustrate by example, on a $65 distribution to a U.S. direct corporate investor, the distributing U.K. corporation pays ACT of $35 to the U.K. Treasury, which in turn pays approximately $13.50 to the U.S. direct corporate shareholder. This payment to the U.S. shareholder is $17.50 (one-half of the $35 credit which would be allowed to a U.K. resident shareholder) less roughly $4 (5 percent of the sum of that $17.50 and the $65 distribution).

For purposes of the U.S. foreign tax credit, the proposed treaty treats the U.S. direct corporate shareholder as receiving a dividend equal to the distribution paid plus an amount equal to one-half of the credit allowable to U.K. shareholders (*Article 10(2)(a)(iii)*), and the reduction in the payment to the U.S. shareholder of 5 percent of the grossed-up distribution is to be treated as a creditable income tax (under Code sec. 901) imposed on the U.S. shareholder (*Article 23(1)(b)*). In addition, the remaining one-half of the amount which would be credited to U.K. residents but which is not refunded to U.S. direct corporate shareholders is treated as creditable income tax imposed on the distributing U.K. corporation the U.S. direct corporate shareholder can claim a deemed-paid foreign tax credit.

For example, on a distribution of $65, the U.S. direct corporate shareholder would be treated as receiving a dividend of $82.50 (the $65 distribution plus one-half of the $35 credit which would be allowed to U.K. resident shareholders), and would be treated as having paid a creditable income tax of 5 percent of that amount, or roughly $4. In addition, the U.K. corporation would be treated as having paid additional income tax of the remaining $17.50 which is not refunded, and the U.S. shareholder will be entitled to an indirect foreign tax credit for that unrefunded $17.50.

The technical explanation of the proposed treaty issued by the U.S. Treasury Department further details the manner in which direct U.S. corporate investors are to compute their U.S. foreign tax credit with respect to dividends received from U.K. corporations. For purposes of computing the indirect foreign tax credit, the technical explanation does not treat the ACT refund which is paid to the U.S. shareholder by the U.K. Treasury (equal to half the credit allowable to U.K. shareholders) as a refund of U.K. tax paid to the U.S. shareholder, but instead treats it as a refund of U.K. tax to the distributing U.K. corporation. The partial refund of the ACT paid to the U.S. shareholders provided in the proposed treaty reduces the maximum effective U.K. tax rate with respect to dividends paid to U.S. shareholders to 42 percent while the U.K. tax rate on retained profits is 52 percent. The effect of the method of computing the foreign tax credit set forth in Treasury's technical explanation is to average the reduced U.K. taxes paid with respect to the distribution with the higher U.K. taxes paid on retained earnings in determining the U.K. tax which is attributed to the dividend distribution.

To illustrate by example, where a U.K. corporation with $200 of taxable income distributes one-half of its $96 of after-tax earnings and the refund paid to the U.S. shareholder reduces the effective rate on the dividend to 42 percent ($52 of tax paid by the corporation reduced by a $10 refund to the U.S. shareholder), the U.S. shareholder would be permitted to average the 52-percent rate paid with respect to the retained earnings and the 42 percent paid with respect to the dividend received and claim a 48-percent foreign tax credit. If the retained profits are subsequently distributed to the U.S. shareholder (thereby lowering the average rate attributable to the previous dividend to 42 percent), the U.S. shareholder is treated as having received a refund of a portion of the U.K. taxes claimed as a foreign tax credit with respect to the earlier dividend.

The Treasury's technical explanation also sets forth a complex set of rules and examples intended to be used for purposes of determining the earnings to which ACT payments by a U.K. corporation are to be attributed for purposes of computing the indirect U.S. foreign tax credit. The technical explanation also sets forth rules for determining the credit where the U.K. corporation has non-U.S. shareholders. These rules are necessary because the treatment of the refund of the ACT to shareholders as a refund of tax to the corporation would distort the average U.K. tax paid by the corporation attributed to its shareholders where the shareholders receive refunds of differing amounts.

Petroleum Revenue Tax.—The proposed treaty also provides that the U.K. Petroleum Revenue Tax (the "PRT") is to be treated as a

creditable income tax for U.S. foreign tax credit purposes. There is some question whether, in the absence of this provision, the PRT would be treated as a creditable income tax under the criteria used by the Internal Revenue Service.

The PRT is imposed at a 45 percent rate on assessable profits from oil and gas extraction activities in the U.K. (including the North Sea) on a field-by-field basis. It is in addition to, and separate from, the regular U.K. corporate tax (and a 12.5-percent royalty payable on North Sea production). The amount of PRT paid is allowed as a deduction for purposes of computing the regular U.K. corporate income tax. Operating and capital losses from nonextraction activities are not allowed as deductions in computing the PRT. In addition, no deduction is allowed for interest or other financing costs. However, a special additional deduction based on the amount of capital investment is provided to compensate for the disallowance of interest expenses in computing profits for purposes of the PRT. The aggregate amount payable to the U.K. Government in taxes and royalties on oil and gas extraction income is roughly 70 percent.

The proposed treaty also makes it clear that the provisions of this article requiring the U.S. to allow a foreign tax credit for U.K. taxes, in particular the PRT, do not affect the limitations on credits for foreign taxes imposed on foreign oil and gas extraction income and foreign oil-related income which are contained in the Tax Reduction Act of 1975. Since the treaty was negotiated prior to the enactment of the Tax Reform Act of 1976, the proposed treaty does not also refer to the limitations on foreign tax credits for oil and gas extraction taxes contained in the 1976 Act. However, since the proposed treaty provisions require only that a U.S. foreign tax credit be allowed in accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle of allowing a foreign tax credit), the additional limitations contained in the 1976 Act, and any similar limitations applying to foreign income taxes imposed on oil and gas extraction income or oil related income which may in the future be adopted, will apply in computing the U.S. foreign tax credit allowable with respect to U.K. taxes on oil and gas extraction income and oil-related income.

Article 24. Nondiscrimination

The proposed treaty contains a comprehensive nondiscrimination provision similar to provisions which have been embodied in other recent U.S. income tax treaties and the OECD model treaty. One country cannot discriminate by imposing more burdensome taxes on its residents who are citizens of the other country, or on permanent establishment maintained in that country by residents of the other country, than it imposes on its nationals and resident corporations. The nondiscrimination provision also applies to corporations or other enterprises of one country which are owned by residents of the other country. The nondiscrimination provision does not, however, oblige either country to grant individual residents of the other country any personal allowances, reliefs, or deductions for taxation purposes on account of personal status or family responsibilities (e.g., dependency deductions) which it grants to its own residents.

The proposed treaty provides generally that interest, royalties, and other disbursements paid by a U.S. enterprise to a U.K. enterprise, whether or not related, shall, if reasonable in amount, be deductible by the U.S. enterprise in computing its U.S. taxable income to the same extent as if they had been paid to another U.S. enterprise. Similarly, such payments by U.K. enterprises to U.S. enterprises are deductible for U.K. tax purposes to the same extent as deductions are allowed for similar payments made to U.K. enterprises. For purposes of this provision, the term "other disbursements" includes charges or allocations for amounts expended by a resident of the other country for the benefit of the enterprise (e.g., amounts expended by a U.S. parent corporation for the benefit of its U.K. subsidiary). It includes a reasonable allocation of executive and general administrative expense incurred on behalf of the enterprise by the resident of the other country (except that it does not include such expenses to the extent that they are not for the benefit of the enterprise, but are for "stewardship" or "overseeing" functions for the resident's own benefit as an investor in the enterprise). The term also includes charges and allocations of research and development expenses where the enterprise has the benefits of such activities under a cost or risk-sharing agreement and other expenditures incurred by the resident for the benefit of a group of related enterprises which includes the resident.

This provision does not apply to interest, royalties, or other disbursements paid or charged to a related resident of the other country to the extent that they exceed the arm's-length amount which would be paid under similar circumstances to an unrelated party. This provision also does not apply to interest payments by a corporation to a U.S. corporation controlled by U.K. shareholders (see *Article 11(7). Interest*). Under certain circumstances such payments are treated as dividends for U.K. tax purposes.

Articls 25 and 26. Administrative provisions

The proposed treaty contains various administrative provisions generally along the lines of the provisions contained in other U.S. tax treaties. In general, the proposed treaty provides—

(1) for consultation and negotiation between the two countries to resolve differences arising in the application of the proposed treaty and also to resolve claims by taxpayers that they are being subjected to taxation contrary to the terms of proposed treaty;

(2) for the exchange between the countries of information pertinent to carrying out the provisions of the proposed treaty and of the domestic laws of the countries concerning taxes covered by the proposed treaty; and

(3) that each country is to assist the other in collecting taxes imposed by the other country to the extent necessary to insure that the benefits provided by the proposed treaty are enjoyed only by persons entitled to those benefits.

Article 27. Diplomatic and consular officials

The proposed treaty contains the rule found in other U.S. tax treaties that its provisions are not to affect the fiscal privileges of diplomatic and consular officials under the general rules of international law or the provisions of special agreements.

Article 28. Entry into force

The proposed treaty will enter into force on the thirty-first day following the date on which of the instruments of ratification are exchanged. Once the proposed treaty enters into force, it applies retroactively, with different effective dates provided with respect to different taxes and provisions.

With respect to the income and capital gains taxes imposed by the United Kingdom, the provisions of the proposed treaty generally apply for any year of assessment beginning on or after April 6, 1975 (the United Kingdom tax year begins on April 6). However, the provision relating to the refund of the ACT and the imposition of the 15 percent withholding tax on dividends paid by United Kingdom corporations to U.S. individual investors and corporate portfolio investors (*Article 10(2)(a)(ii)*) applies with respect to dividends paid after April 1, 1973 (the date the ACT system came into effect). The proposed treaty will apply with respect to the corporation tax for any financial year beginning on or after April 1, 1975. With respect to the petroleum revenue tax, it applies for any chargeable period beginning on or after January 1, 1975 (the date the PRT first came into effect).

The proposed treaty will generally apply on a retroactive basis to taxes imposed in the United States (including State income taxes subject to the limitations provided in Article 9(4)) for taxable years beginning on or after January 1, 1975. The proposed treaty applies to any U.S. withholding taxes paid or credited on or after January 1, 1975, without regard to when the taxable year began. In addition, the provisions under which the United States is required to allow a foreign tax credit for United Kingdom taxes (including the income tax, the capital gains tax, the corporation tax, the unrefunded ACT, the deemed withholding tax, the petroleum revenue tax, and local taxes) apply with respect to United Kingdom taxes paid on or after April 1, 1973.

The provisions of the existing treaty will generally cease to have effect on a retroactive basis with respect to a tax to which the proposed convention applies at the time the proposed treaty comes into effect with respect to that tax. However, where any provisions of the existing treaty would have afforded greater relief from tax, that provision will continue to have effect for any taxable year beginning before January 1, 1976. The existing treaty will terminate on the last date on which it has effect under the above provisions.

The termination of the existing treaty will not, however, affect agreements which extend the existing treaty to certain territories of the United Kingdom (Antigua, Belize, the British Virgin Islands, Dominica, the Falkland Islands, Montserrat, St. Christopher-Nevis-Anguilla, St. Lucia, and St. Vincent). In those cases, the existing treaty will continue to apply. However, the United States has requested the United Kingdom to advise those territories that the United States desires to renegotiate the existing treaty as it affects them so as to reflect the principles of the proposed treaty.

Article 29. Termination

The proposed treaty will continue in force indefinitely, but either country may, on or before June 30 of any year after 1980, terminate it by giving notice through diplomatic channels.

If such notice is given, the treaty will cease to be effective for taxable years beginning on or after January 1 of the following year for U.S. tax; for a year of assessment beginning on or after April 6 of the following year for the U.K. income tax and capital gains tax, for a financial year beginning on or after April 1 of the following year for the U.K. corporation tax; and for a chargeable period beginning on or after January 1 of the following year for the U.K. petroleum revenue tax.

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